Daiwa Capital Markets

Euro wrap-up

Overview

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- Bunds followed USTs higher despite a modest upside surprise to the latest euro IP data while Bonos underperformed after yesterday's moves towards the formation of a new left-wing Spanish coalition government.
- Gilts also made significant gains as UK inflation fell to its lowest level since 2016.
- Thursday's new economic data releases include the first estimate of German GDP in Q3 and UK retail sales figures for October.

Daily bond market movements

Bond	Yield	Change
BKO 0 09/21	-0.639	-0.013
OBL 0 10/24	-0.561	-0.028
DBR 0 08/29	-0.304	-0.048
UKT 3¾ 09/21	0.549	-0.012
UKT 1 04/24	0.527	-0.034
UKT 0⅞ 10/29	0.755	-0.052

*Change from close as at 4:30pm GMT.
Source: Bloomberg

Euro area

Euro area IP contracts in Q3

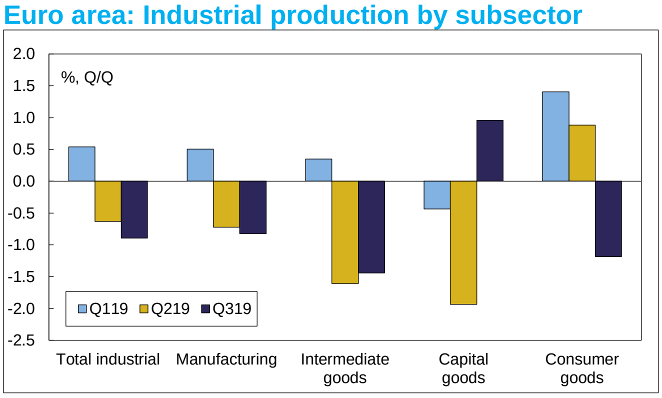
While sentiment surveys signalled a significant deterioration in manufacturing conditions at the end of Q3, today's euro area IP figures for September provided a modest upside surprise, with a second successive monthly increase contrasting with declines in three of the largest four member states. But growth of 0.1%M/M still left output down almost 2% compared with a year earlier. And the monthly increase was thanks to an extraordinary surge in production in Ireland (8.8%M/M), in what is a notoriously volatile series. Within the euro area detail, there was further recovery in production of capital goods, which rose for the third consecutive month (0.6%M/M) to leave it up an encouraging 1%3M/3M, the strongest such growth for eleven months. But while production of consumer non-durables accelerated (1.0%M/M), output of intermediate goods fell for the sixth month out of the past seven (-0.9%M/M). And over the third quarter as a whole, production in both subsectors was down more than 1%3M/3M, to leave overall manufacturing output 0.8% lower in Q3. With energy production having also declined in Q3, total IP was down 0.9%3M/3M, marking the third quarterly contraction out of the past four. And surveys have so far implied little improvement in conditions in the sector at the start of Q4 either, with perhaps most notably the European Commission's industrial sentiment indicator having declined in October to its lowest since mid-2013 as manufacturers expressed greater pessimism about near-term production expectations.

Spanish coalition to be in government by Christmas?

With remarkable haste after Sunday's inconclusive General Election, yesterday afternoon saw Spain's ruling Socialist party (PSOE) reach a preliminary deal with the populist left-wing Podemos party to form the basis of a coalition government. There was little detail agreed on policy. But reports today suggested that there would be three Deputy Prime Ministers, one of whom would be Podemos leader Pablo Iglesias, while PSOE leader Pedro Sánchez would inevitably be Prime Minister. Importantly perhaps, PSOE (with 120 seats) and Podemos (35 seats) collectively still fall some way short of the 176 seats required for a parliamentary majority. As such, to be able to form the next government and avoid new elections in the spring, they will need endorsement of some other small regional parties and an abstention from the Catalan Republican Left (ERC) separatist party (13 seats).

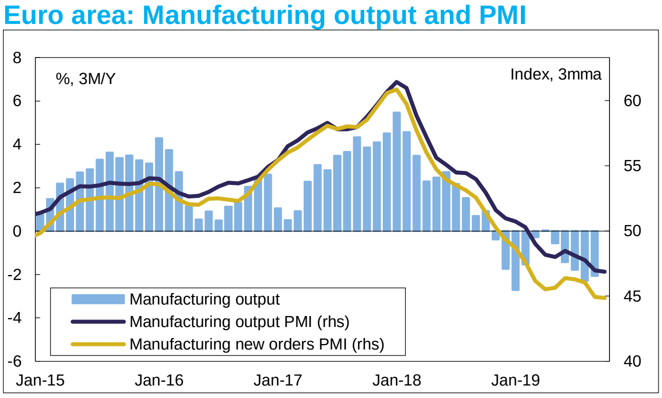
Given the rising threat from the right-wing parties – the establishment Partido Popular (88 seats, up 22 from the previous election in April) and nationalist Vox (52 seats, up 28) – we now expect the PSOE/Podemos government eventually to be formed, albeit not for a little while yet. The new Parliament will be constituted on 3 December. And after the King has subsequently held consultations with the party leaders, votes to confirm the appointment of the new Prime Minister could be held after about a fortnight, allowing the new Government to be in place by Christmas.

Euro area: Industrial production by subsector



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Euro area: Manufacturing output and PMI



Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

A looser fiscal policy, but still compatible with EU rules?

So what might this all mean for economic policy? If the PSOE-Podemos coalition is indeed able to govern and a budget is eventually passed in the New Year, that would highly likely result in increased public expenditure – not least targeted on some of the regions to help secure the backing of the relevant small political parties – amid a somewhat looser fiscal policy. However, although the general government budget deficit would likely increase from about 2¼% of GDP this year, it would still likely remain below 3% of GDP in 2020 as the coalition would retain a pro-EU bias. Prospects for investor-friendly structural reform (including privatisation of Bankia) might seem low. But increases in public pensions and the minimum wage would seem likely. While events in Catalonia might continue to cast a shadow, an emphasis on dialogue within the framework of the current constitution, rather than confrontation (which would likely have been the major theme if the right-wing parties had come to power) would likely be the strategy.

The day ahead in the euro area and US

It will be a busy day for economic releases tomorrow, with perhaps most notable being the first estimate of German Q3 GDP. Given the significant weakness in industrial and construction output in the third quarter, there is a significant risk that tomorrow's figures will confirm a technical recession in the euro area's largest member state, with the consensus expectation for growth of -0.1%Q/Q. We are a touch less downbeat given the pickup in retail sales that quarter, admittedly merely forecasting GDP growth of zero in Q3. Meanwhile, the updated estimate of euro area Q3 GDP growth is expected to align with the flash estimate of 0.2%Q/Q (unchanged from Q2). Against this backdrop, euro area labour market figures are likely to show employment growth in Q3 no firmer than the 0.2%Q/Q rate in Q2. And ahead of Friday's release of final euro area inflation for October, Thursday will bring revised CPI estimates from France and Spain (today's figures from Germany confirmed the respective flash estimate of 0.9%Y/Y on the EU-harmonised measure). Elsewhere, tomorrow will see ECB Vice-President de Guindos and Chief Economist Lane speak at separate events in London and Frankfurt. And the ECB should also publish any detail of agreements reached at today's Governing Council meeting on non-monetary policy issues.

In the US, a quieter day for economic data tomorrow will bring just October's PPI figures and weekly jobless claims numbers.

UK

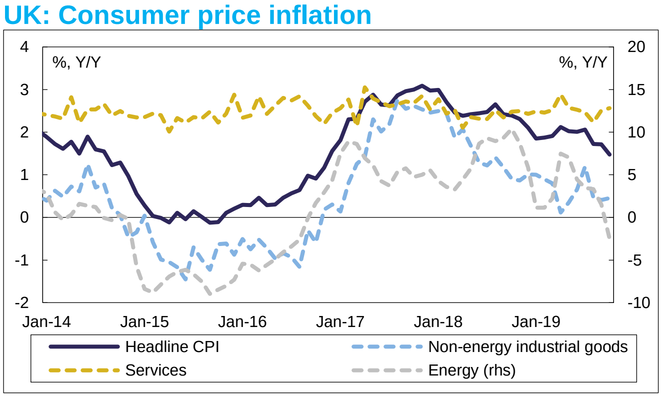
Headline CPI declines to a near-3-year low

There were no major surprises from today's UK inflation release, which confirmed a further easing in the headline CPI rate in October by 0.2ppt to 1.5%Y/Y, a touch weaker than the consensus forecast but in line with the BoE's assumption in last week's Monetary Policy Report. Against the backdrop of Ofgem's reduced price caps on tariffs last month, the principal source of downward pressure came from energy inflation, which fell 4.1ppts to -2.5%Y/Y, the first negative reading since August 2016, with gas and electricity prices down 8.7%M/M and 2.2%M/M respectively. But services inflation edged slightly higher in October, up 0.1ppt to 2.6%Y/Y, while inflation of non-energy goods was also up 0.1ppt to 0.5%Y/Y, principally on the back of the strongest year-on-year increase in clothing prices (½%Y/Y) for seventeen months. Nevertheless, core inflation was unchanged at 1.7%Y/Y, to match the average rate of the prior five months and close to the bottom of the range of the past three years.

Price pressures to remain subdued

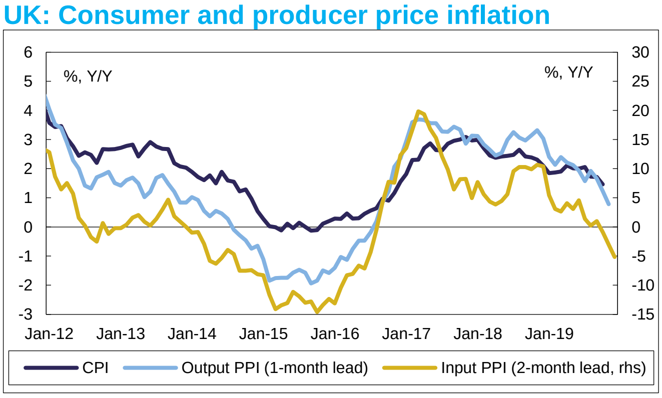
Today's producer price inflation release suggested that price pressures down the pipeline continue to weaken too. For example, input price inflation fell more than 2ppts to -5.1%Y/Y, the lowest since 3½ years, while output producer price inflation fell 0.4ppt to 0.8%Y/Y, with core output price PPI also down 0.4ppt to 1.3%Y/Y, the lowest since July 2016. And the weak economic environment, including the recent softening of the labour market and likelihood of negative GDP growth in Q4, should ensure underlying price pressures remain relatively subdued over coming quarters. Indeed, while headline CPI

UK: Consumer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

UK: Consumer and producer price inflation



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

might rise back towards 2%Y/Y at the turn of the year, like the BoE, we expect it to resume a downward trend through 2020, to average around 1½%Y/Y over the year as a whole, further supporting our view that the BoE will in due course feel it appropriate to ease policy, by cutting Bank Rate by 25bps to 0.50%.

The day ahead in the UK

The main UK economic focus tomorrow will be on the release of October retail sales numbers, which are expected to show a modest increase in spending at the start of Q4 despite still weak consumer and retailer sentiment surveys. The RICS house price survey will also provide an update on housing market conditions at the start of Q4. In the markets, tomorrow will see the DMO sell 30Y Gilts.

European calendar

Today's results

Economic data

Country	Release	Period	Actual	Market consensus/ *Daiwa forecast*	Previous	Revised
EMU	Industrial production M/M% (Y/Y%)	Sep	**0.1 (-1.7)**	-0.2 (-2.3)	0.4 (-2.8)	-
Germany	Final CPI (EU-harmonised CPI) Y/Y%	Oct	**1.1 (0.9)**	1.1 (0.9)	1.2 (0.9)	-
UK	CPI (core CPI) Y/Y%	Oct	**1.5 (1.7)**	1.6 (1.7)	1.7 (1.7)	-
	PPI output prices (core output prices) Y/Y%	Oct	**0.8 (1.3)**	0.9 (1.5)	1.2 (1.7)	-
	ONS house price index Y/Y%	Sep	**1.3**	1.1	1.3	-

Auctions

Country	Auction
Germany	sold €2.4bn of 0% 2029 bonds at an average yield of -0.29%
Italy	sold €2.5bn of 0.05% 2023 bonds at an average yield of 0.22%
	sold €3.3bn of 0.85% 2027 bonds at an average yield of 0.91%
	sold €0.6bn of 2.7% 2047 bonds at an average yield of 2.14%
	sold €0.9bn of 3.85% 2049 bonds at an average yield of 2.29%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's data releases

Economic data

Country	BST	Release	Period	Market consensus/ *Daiwa forecast*	Previous
EMU	10.00	GDP – second estimate Q/Q% (Y/Y%)	Q3	0.2 (1.1)	0.2 (1.2)
	10.00	Employment Q/Q% (Y/Y%)	Q3	-	0.2 (1.2)
Germany	07.00	GDP – first estimate Q/Q% (Y/Y%)	Q3	-0.1 (0.4)	-0.1 (0.4)
France	07.45	Final CPI (EU-harmonised CPI) Y/Y%	Oct	0.7 (0.9)	0.9 (1.1)
Spain	08.00	Final CPI (EU-harmonised CPI) Y/Y%	Oct	0.1 (0.2)	0.1 (0.2)
UK	00.01	RICS house price balance	Oct	-3	-2
	09.30	Retail sales including fuel M/M% (Y/Y%)	Oct	0.3 (3.7)	0.0 (3.1)
	09.30	Retail sales excluding fuel M/M% (Y/Y%)	Oct	0.3 (3.6)	0.2 (3.0)

Auctions and events

Country	BST	Auction / Event
EMU	-	ECB's Guindos, Lane and Knot are scheduled to speak
UK	10.30	Auction: to sell 1.75% 2049 bonds

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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